Eurobank Research
www.eurobank.gr/research
research@eurobank.gr

NEW EUROPE
ECONOMICS & STRATEGY
Issue 12 | February 2011

Written By:

Gikas Hardouvelis:
Chief Economist & Director of Research

Platon Monokrousos:
Head of Financial Markets Research Division

Tasos Anastassatos:
Macro Strategist

Ioannis Gkionis:
Research Economist Coordinator of Macro Research

Stella Kanellopoulou:
Research Economist

Galatia Phoka:
Emerging Markets Analyst

SPECIAL CONTRIBUTION:
Dan Bucşa
Head of Research Bancpost S.A.

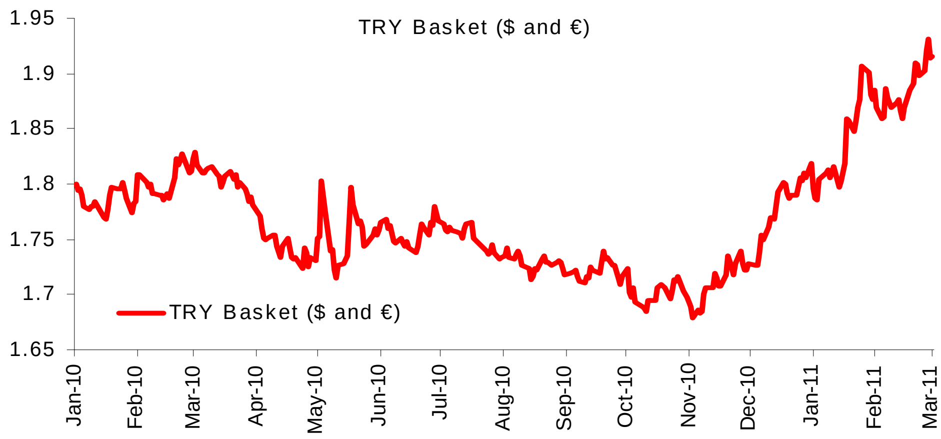
Macroeconomic outlook remains positive but geopolitical risks linger

Bulgaria: Economy exited recession in 2010, with real GDP growth accelerating to 0.3%, after contracting by 5% a year earlier
Poland: Q4:2010 GDP growth accelerated to 4.4% yoy, from 4.2% yoy in the prior quarter. National Bank of Poland kept its key policy rate unchanged to 3.75% in early March; additional policy tightening expected ahead
Romania: New IMF/EU precautionary agreement to replace present arrangement when it expires in April 2011
Serbia: The resignation of Deputy Prime Minister and Minister of Economy Mladan Dinkic increases worries over the stability of the present coalition government, which term expires in mid 2012. The Central Bank left its key policy rate unchanged at 12.00% on February 12, but maintained tightening bias
Turkey: Strong growth momentum to be maintained in Q1:2011
Ukraine: Real GDP growth slowed to 3.0% yoy in Q4: 2010, from 3.4% yoy in the prior quarter, mainly due to base effects.

New Europe market strategy highlights

In **regional currencies** markets, the Hungarian forint and the Serbian dinar remain top performers in New Europe with further upside potential seen ahead. We continue to favor short EUR/RSD positions, targeting 98.40 in 3 to 6 months. Meanwhile, our earlier EUR/HUF short recommendation hit our stop-loss (275) in late February. Yet, in view of the forint's relative outperformance vis other regional currencies, we see further downside potential in PLN/HUF. Elsewhere, we also favor shorting the EUR/PLN on an outright basis or via options, at levels of 4.000-4.050 with a target of 3.800 and stops above 4.055. Short positions in the EUR/TRY may also bear some value with the lira's recent weakening likely to prove overdone. **In the sovereign credit space**, Turkey's recent underperformance provides a potential window of opportunity, especially in view of a possible upgrade of the country's credit rating later this year. A retest of October's multi-year lows in the 5year CDS spread is possible, particularly if oil prices reverse their recent uptrend. As such, we favor entering short positions at the current levels near 170bps, with a stop at 185bps and a target of 140bps. We continue to like short positions in Romania's 1-year CDS and longs in the 8.50% May 2012 EUR-denominated Eurobond as the country's fiscal position appears to be improving gradually, supported by the IMF anchor. Rising inflation and political risks in view of the escalating turmoil in the Middle East, in tandem with narrowing output gaps in New Europe, do not favor **local rates markets**. The recent sharp rise in commodity prices has triggered concerns that many central banks in the New Europe may fall behind the curve as inflation risks increase.

Turkish lira under pressure on geopolitical tensions, CBT unconventional monetary policy mix



Source: Bloomberg

Table of contents

Introductory Comment 3

Eurobank EFG Research Forecasts 5

I. Overview 6

II. New Europe - Country Analysis

a. Bulgaria:	Output recovery accelerated in Q4:2010	9
b. Poland:	Policy rate left unchanged in March; room for further NBP tightening ahead	11
c. Romania:	New two-year precautionary agreement is announced	13
	Focus Romania The end of recession is in sight…	16
d. Serbia:	Domestic political noise on the rise	19
e. Turkey:	Strong growth momentum likely to be maintained throughout Q1:2011	22
f. Ukraine:	2011 outlook looks encouraging	26

Introductory Comment

Dear Reader,

A number of countries in New Europe have already published their flash GDP estimates for Q4:2010. Of the group of economies covered in this issue, Bulgaria, Poland, Romania, and Serbia reported Q4 GDP data, which have been broadly in line with our expectations. The key take away from those releases is that the economic recovery remains on track across the region.

Economic recovery in 2010 was driven primarily by higher net exports. The rebuilding of inventories and base effects also pushed growth rates to positive territory. However, as it is becoming increasingly evident from Q4 data, a more balanced pattern of growth will emerge in the coming quarters given the improved prospects for a domestic demand recovery. Risks to that view lie in the face of increased food and energy inflation, the current social upheaval in the Middle East and North Africa (MENA) and developments related to the lingering EMU sovereign debt crisis.

The upside inflationary risks we had warned about in our recent *New Europe Economics & Strategy* issues have fully materialized in late 2010/early 2011. Elevated food and energy prices as well as excise tax hikes have already pushed CPI readings higher. The current upheaval in MENA region weighs even more negatively on the near-term inflation outlook, representing a serious headwind for consumers and policy policymakers alike.

With respect to country-specific developments,

Output recovery in **Bulgaria** accelerated in Q4, with full-year GDP growth turning marginally positive at 0.3%. Real GDP expanded by 1.7% qoq/2.1% yoy in Q4 vs. 0.7% qoq/0.5% yoy in Q3. This performance places Bulgaria among the four EU countries with the strongest quarter-on-quarter growth in the fourth quarter of last year.

In **Romania**, the growth laggard among New Europe economies in 2010, an end of recession is finally in sight. The news from the data front is encouraging, pointing to signs of bottoming out in domestic economic activity. Output contraction slowed sharply from -2.5% yoy in Q3 to -0.6% yoy in Q4, bringing the pace of GDP contraction for the full year to -1.3% *i.e.,* significantly higher than market expectations for a -2.0% readings.

Driven primarily by net exports, **Serbia** grew by 1.7% yoy in 2010. In spite of the recent rise in domestic political jitters, growth in 2011 is expected to accelerate to 3%, driven by strengthening domestic demand. Implementation of the existing IMF program has so far been successful, shielding the country against external financing shocks, while the banking sector remains in a sound condition, continuing to channel credit to the domestic economy.

In view of the escalating tensions in North Africa and the Middle East, **regional stock markets** came under pressure in recent sessions. Not only has the turmoil raised concerns about political instability in the wider region, but it has also fanned worries over inflation and the pace of global economic growth in view of higher oil prices. Nonetheless, most regional stock markets remain in positive territory year-to-date, continuing to broadly outperform emerging market peers in Asia and Latin America. Turkey has been among the exceptions, with its construction companies having a high exposure in Libya. Growing concerns about rising pressures on inflation and the current account deficit -- as the country is a large energy importer – as well as broadly unconventional monetary policy mix employed by the CBT since last December have also weighed on Turkish assets.

Similarly, **local rates** and **external debt markets** came under renewed pressure in recent weeks on escalating geopolitical tensions and growing inflation risks, adding to concerns that regional central banks may fall behind the (policy tightening) curve.

In the **foreign exchange markets,** local currencies broadly weakened over the last few weeks in view of the escalating geopolitical tensions and scaled-back monetary tightening expectations in several countries in New Europe. Even so, most currencies remain near recent highs, being supported by hopes of accelerating growth in regional economies this year. The Hungarian forint and the Serbian dinar remain the outperformers in New Europe, being primarily driven by proactive Central Banks and easing fiscal concerns. On the other hand, the Turkish lira remains a laggard, weighed down by the CBT's monetary policy mix and rising tensions in Libya.

Prof. Gikas A. Hardouvelis

Group Chief Economist & Director of Research

Summary of key macroeconomic indicators

Realizations and forecasts

	Real GDP (yoy)			Consumer Prices (p.a.)			Fiscal Balance (%GDP)		
	2009	2010	2011	2009	2010f	2011f	2009	2010	2011f
Bulgaria	-5.0	0.3	2.5	2.5	3.0	2.7	-0.9	-3.9	-2.8
Poland	1.7	3.8	4.0	3.5	2.6	3.2	-7.1	-7.9	-7.0
Romania	-7.1	-1.3	1.5	5.6	6.1	5.5	-7.4	-6.5	-4.4
Serbia	-3.0	1.7	3.0	8.2	6.5	9.0	-4.2	-4.4	-4.0
Turkey	-4.7	8.0	5.0	6.3	8.6	5.2	-5.5	-3.6	-2.7
Ukraine	-15.1	4.2	4.5	15.9	9.4	10.8	-8.7	-6.5	-3.5
New Europe	-4.3	-4.7	4.1	6.5	6.3	5.4	-6.4	-5.6	-4.3
Euro area	-4.1	1.7	1.9	0.3	1.6	2.0	-6.3	-6.3	-5.0
USA	-2.6	2.9	3.9	-0.3	1.6	2.3	-12.9	-8.9	-9.8

	Current Account (%GDP)			Policy Rate (e.o.p.)			FX* (e.o.p.)		
	2009	2010	2011	2010	current	2011f	2010	current	2011f
Bulgaria	-9.9	-0.8	-2.5	currency board			1.96	1.96	1.96
Poland	-2.2	-3.3	-3.5	3.50	3.75	4.50	3.96	3.97	3.90
Romania	-4.4	-4.2	-6.0	6.25	6.25	5.50	4.28	4.20	4.30
Serbia	-6.9	-7.0	-9.0	11.50	12.00	10.00	106.1	103.9	105.0
Turkey	-2.3	-6.5	-7.0	6.50	6.25	7.50	1.54	1.60	1.45
Ukraine	-1.5	-1.9	-2.5	7.75	7.75	7.75	7.94	7.95	7.90
New Europe	-2.8	-4.5	-5.1	-	-	-	-	-	-
Euro area	-0.6	-0.3	0.0	1.00	1.00	1.50	1.34	1.39	1.42
USA	-2.7	-3.3	-3.2	0.125	0.125	0.125	0.75	0.72	0.70

Source: National statistics, IMF, EC, Eurobank Research forecasts
vs. EUR (TRY and UAH vs. USD)

I. Overview

Recovery remained on track in Q4; domestic demand revival points to more balanced growth dynamics in 2011

The latest bout of GDP data from New Europe confirmed that economic recovery continued during the last quarter of 2010. Domestic demand remained anaemic in most economies in the region amid weak labour market conditions, fiscal austerity and reduced credit availability. On the other hand, higher external demand remained the primary engine of GDP growth. In detail, Hungary's real GDP growth picked up pace in Q4 2010, coming in at 2.0%yoy, from 1.7% yoy in the prior quarter on the back of higher exports. Consequently, full-year growth registered a 1.2%yoy increase, following a 6.7%yoy contraction in 2009. In a similar mode, Bulgaria's gross domestic product gained momentum in Q4, with the domestic economy growing by 2.1%yoy after a 0.5%yoy increase in Q3. In seasonal adjusted terms, quarter-on-quarter GDP growth accelerated to 1.7% in the last quarter of 2010, from 0.7% a quarter earlier. For the whole of last year, real GDP recorded a slightly positive print (+0.3%) compared with a 4.7% contraction in 2009. Elsewhere, the economies of Serbia and Ukraine expanded at respective rates of 1.7% and 4.2% in 2010, following declines of 3.0% and 15.1% in 2009, with the economic revival being primarily driven by higher exports. In Romania, which proved the primary growth laggard in New Europe in 2010, the 0.6% yoy real GDP contraction in Q4 was driven by a 2%yoy decline in domestic consumption and a 4.7%yoy plunge in investments. These pushed 2010 full-year growth to -1.3%. However, on a quarter-on-quarter basis real economic activity accelerated by 0.1% in Q4, according to seasonally adjusted data, suggesting that an economic stabilization is probably underway. Poland, which along with Turkey are proving to be the region's top growth performers, recorded 4.4%yoy growth in Q4, bringing the 2010 full-year print to 3.8%. Last but not least, 2010 GDP growth in Turkey is estimated to have reached ca 8%yoy. In all, the latest GDP data in New Europe suggests a more balanced pattern of growth in the coming quarters in view of improving domestic demand dynamics. Even so, primary risks to this year's growth dynamics lie in the face of rising inflation pressures, the turmoil in North African and Middle East and the ongoing debt crisis in the euro area.

Regional stock markets come under pressure on rising geopolitical fears

Equity markets in New Europe came under pressure in recent weeks weighed down by rising political and social tensions in North Africa and the Middle East. The lingering turmoil is fanning appreciating pressures in commodity prices, boosting concerns about rising inflation pressures. Ensuing risks are also particularly relevant for counties with a large oil-import component in their trade balances. Nevertheless, losses in most regional stock markets have been largely capped by investors' optimist over the prospects of the global economy and hopes that a more holistic and comprehensive policy response to the lingering EMU debt crisis will be provided in the non too distant future. Local bourses in New Europe continue to broadly outperform emerging market peers in Asia and Latin America so far this year, as the spillover impact of the turmoil in the Middle East is likely to have a relatively limited impact for most economies in the region. Turkey has so far been an exception, with domestic assets having been among the most hit in recent days; one important reason being the country's close economic links with Libya. Turkish construction companies have a high exposure in the country, with projects there estimated to be worth some $15.3bn. Meanwhile, the recent spike in oil prices is fanning inflation and balance-of-payments related concerns as Turkey is a large energy importer. An unconventional monetary policy mix employed by the CBT since last December has also weighed on Turkish assets. At the market close of March 1, the benchmark MSCI Emerging Market Equity index recorded year-to-date losses to the tune of 3.4%. Over the same period, the corresponding Emerging Europe equity sub-index gained 4.8%, with a further upside capped by an 11% plunge in Turkey's main stock index XU100. Separately, LATAM and Emerging Asia remained posed among the primary underperformers, each registering losses to the tune of 4% year-to-March 1. BRICS followed suit with a 2.4% fall over the same period. Even so, most indices remain within distance from multi year highs touched in January, supported by global economic recovery optimism. In particular, the Emerging Europe sub-index, which is comprised of the Czech Republic, Hungary, Poland, Russia and Turkey, stood on March 1 slightly below a 28-month peak of 566.93 achieved on February 8. In New Europe, Serbia's BELEX15 and Bulgaria's SOFIX remain the region's star performers so far this year, with respective year-to-date gains of ca 17% and 22%. Ukraine's PFTSI followed suit having advanced by 16%.

Regional bond markets remain under pressure; Turkey and Poland underperform

Local rate markets remained under pressure in recent weeks as the escalating tensions in North Africa and Middle East have boosted inflation concerns, with the lingering debt crisis in the EMU-periphery also weighing. Turkey and Poland posed among the region's worst performers in view of strong domestic demand dynamics, while the crisis in Libya is taking a further toll on Turkish government bonds as it exacerbates inflation and financial stability concerns. As a result, Turkey's 2-year benchmark note yield rose above 9% on March 2, its highest level since May 2010. The corresponding yield is now around 170bps higher relative to its levels in the beginning of the year. Meanwhile, Polish government paper has also underperformed so far this year, as domestic inflation and, primarily, fiscal concerns continued to weigh. The 2- year POLGB yield was ca 30bps higher in early March compared to its levels at the end of December, having touched a new 1-year peak of 5.19% on February 21. In a similar vein, the yield of the 10-year benchmark paper rose 24bps over the last couple of months hovering around 6.30% at the time of writing. The latter is not far from a 1-½-year peak around 6.45% touched in mid-January. In Hungary, the short-end of the bond yield curve outperformed longer-maturity paper on easing rate hike expectations and some market disappointment following the announcement of the government's fiscal consolidation plan. The latter failed to include as much detail as investors had apparently hoped for. Along these lines, the 3-year government bond yield fell by ca 1bps over the last month to 6.84% in early March, while the 10-year yield rose by ca 6bps to 7.37% over the same period.

Regional FX markets off recent highs on escalating geopolitical risks, easing rate hike expectations

Regional currencies have broadly weakened over the last few weeks in view of the escalating tensions in the North Africa and the Middle East as well as scaled-back monetary tightening expectations in a number of economies in New Europe. Yet, most remain close to recent highs touched in early February, receiving support from hopes about a sustainable recovery in the region later this year. The **Hungarian forint** remains a top performer on fiscal consolidation hopes, with the EUR/HUF having touched a 9-month trough of 267.07 in early February. Similarly, the **Serbian dinar** stands no far from a 9-month peak of 102.04/EUR achieved in late February. **Romania's leu** staged a rally in recent weeks, apparently boosted by rumored central bank intervention. As a result, the EUR/RON touched an 8-month trough of 4.1900 on March 3. Elsewhere, the **Turkish lira** remains a major underperformer in New Europe, having retreated by ca 5% against the USD year-to-date, as the CBT's policy mix and the turmoil in the Middle East continue to weigh on the currency. Separately, the **Polish zloty** has extended its downtrend vs. the EUR after touching a near 1-year peak of 3.8250 in January, weighed down by fiscal-related concerns.

External debt markets regain composure, Turkey lags

External debt markets in New Europe recouped part of their recent losses. Even so, Turkey lagged the region's trend as the country's contractors have a high exposure to Libya, while the ongoing rise in oil prices is stirring concerns about higher inflation and a widening current account deficit. Turkey's 5-year CDS spreads stand ca 40bps wider since late-December having hit a 6-montht peak of 182.1bps in late February. Hungary remains the region's best performer on fiscal consolidation hopes, with the 5-year CDS spreads having shrunk more than 20% year-to-March, after touching a 3-month trough of 278.713 on February 7.

Strategy - Emerging New Europe Markets

FX: The **Hungarian forint** and the **Serbian dinar** remain top performers in New Europe with further upside potential seen ahead, against a background of proactive central bank monetary tightening and improving domestic demand dynamics. We continue to favor short **EUR/RSD** positions at current levels around 103-104, targeting 98.40 in 3 to 6 months. Meanwhile, our earlier **EUR/HUF** short recommendation hit our stop-loss (275) in late February. Yet, in view of the forint's *relative* outperformance *vis* other regional currencies, we see further downside potential in the **PLN/HUF**. As such, we favor entering short PLN/HUF positions at levels around 68 targeting 64 with a stop loss at 70 (200-day MA). Elsewhere, we also favor shorting the **EUR/PLN** on an outright basis or via options, at levels of 4.000-4.050 with a target of 3.800 and stops above 4.055. Short positions in the **EUR/TRY** may also bear some value with the lira's recent weakening (1-year low of 2.2476 on March 2) likely to have been overdone. We favor shorting the pair at levels around 2.24, strops at 2.25 or higher and a target of 2.00.

In the sovereign credit space, Turkey's recent underperformance provides a potential window of opportunity, especially in view of a possible upgrade of the country's credit rating later this year. A retest of October's multi-year lows in the 5year CDS spread is possible, particularly if oil prices reverse their recent uptrend. As such, we favor entering short positions at the current levels near 170bps, with a stop at 185bps and a target of 140bps. We continue to like short positions in Romania's 1-year CDS at current levels near 200bps as well as longs in the 8.50% May 2012 EUR-denominated Eurobond as the country's fiscal position appears to be improving gradually, supported by the IMF anchor (a new deal was announced in February in replacement of the one that expires in March). The domestic economy slowly rebounding from recession is also likely to favor. A long position in Poland's 5-year CDS vs. a short in Russia's 5-year CDS appears attractive as a pure oil play on the latter and fiscal concerns on the former. Under current conditions we would enter long at a 0-5bps spread, with a stop-loss at -5 and a target near 25. Elsewhere, Bulgaria's 8.25% January 2015 appears to be luring strong demand lately, with spreads over asset swaps at levels of 166bps, currently. The 4-year CDS spread presently stands higher, at 220bps. Accordingly, entering short positions in the 4-year CDS at levels of 230bps with a target of 200bps and a stop loss ca 30bps above our entry level appear attractive.

Rising inflation and political risks in view of the escalating turmoil in the Middle East, in tandem with narrowing output gaps in New Europe, do not favor **local rates markets.** The recent sharp rise in commodity prices has triggered worries over derailing the pace of the global economic activity and fanning concerns that many central banks in the New Europe may fall behind the curve as inflation risks augment. This, in turn, will likely result to more aggressive monetary policy tightening by regional Central Banks in the imminent future while concerns about rising inflation pressures remain on the rise. Along these lines local yield curves have undergone bearish steepening in recent weeks and given the high uncertainty surrounding the global inflation outlook and future monetary policy trajectories ahead we prefer to stay sidelined in the region's local rates markets for the time being.

Written by
Platon Monokroussos
Assistant General Maanger
Head of Financial Markets Research
pmonokrousos@eurobank.gr

Galatia Phoka
Emerging Markets Analyst
gphoka@eurobank.gr

Special thanks to:
Costas Katsileros
Christos Pnevmatikatos
Konstantinos Dimaresis

II. New Europe – Country Analysis: **Bulgaria**

Bulgaria: Output recovery accelerated in Q4:2010

- Bulgaria exited recession in 2010, with real GDP growth accelerating to 0.3%, after contracting by 5% a year earlier
- Deputy Prime Minister, Symeon Djankov, stated that Bulgaria is not planning a Eurobond issue to finance this year's budget deficit
- In its latest progress report on Bulgaria, the European Commission cited partial progress made in judicial reform and the fight against organized crime, urged government to maintain reforms momentum

Output recovery accelerated in Q4: 2010

Domestic economic activity recovered further in the last quarter of 2010. According to a flash report released by the Statistical Service, real GDP expanded by 1.7% qoq in Q4 vs. 0.7% qoq in Q3. This performance placed Bulgaria among the four EU countries with the strongest quarter-on-quarter growth performance in the fourth quarter of last year. Having seen the worst of the domestic economic downturn in Q4 2009, Bulgaria exited recession in Q3 2010, at least from a technically standpoint, defined as the generation of two consecutive quarters of positive GDP growth.

On a yearly basis, real GDP grew by 2.1% yoy in Q4 compared to 0.5% yoy in Q3. From a sectoral standpoint, only services were still mired in negative territory in Q4. The contribution of both agriculture and industry was positive. Agricultural output expanded by 4.8% yoy in Q4 against 3.0% yoy in Q3. Industry registered a strong performance in Q4, expanding by 3.6% yoy, following a 1.3% yoy contraction in the prior quarter. In contrast, services declined by 1.8% yoy in Q4 vs. -1.4% yoy in Q3. However, on a quarter-on-quarter basis, the latter's pace of contraction slowed to -0.2% yoy in Q4 from -0.8% yoy a quarter earlier.

From the demand side, both consumption and investments improved. The contraction of private consumption slowed to -1.3% yoy in Q4 vs. -6.4 yoy in Q3. Investments still exerted a negative contribution in Q4. The 4.7% yoy rise in gross fixed capital formation (the first since Q4 2008) was offset by the decline in inventories, so that gross capital formation declined by -2.1% yoy in Q4 vs. -4.9% yoy in Q3. The performance of the external sector remained strong, but it didn't manage to keep up the pace recorded in Q3. Exports growth slowed down to 10.7% yoy in Q4 vs. 18.5% yoy in Q3. In contrast, imports recovery gained momentum in Q4. Imports recovered by 6.9% yoy in Q4 vs. 3.0% yoy in Q3.

Bulgaria: Eurobank EFG Forecasts

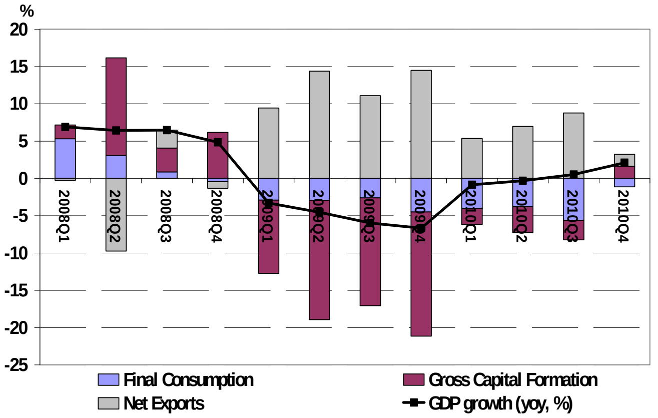
	2008	2009	2010	2011f
Real GDP (yoy%)	6.0	-5.0	0.3	2.5
Final Consumption	6.0	-5.0	-4.1	2.0
Gross Capital Formation *(Fixed)*	20.4	-26.9	-9.0	2.5
Exports	2.9	-9.8	11.8	5.0
Imports	4.9	-22.3	1.8	4.0
Inflation (yoy%)				
HICP (annual average)	12.0	2.5	3.0	2.7
HICP (end of period)	7.2	1.6	4.4	3.0
Fiscal Accounts (%GDP) - *Cash Basis*				
General Government Balance	2.9	-0.9	-3.9	-2.8
Gross Public Debt	15.5	15.5	16.7	19.5
Primary Balance	3.7	-0.2	-3.3	-2.0
Labor Statistics - *National Definitions*				
Unemployment Rate (registered, %)	6.3	9.1	9.2	8.9
Wage Growth *(total economy)*	26.5	11.8	6.3	5.0
External Accounts				
Current Account (% GDP)	-23.1	-9.9	-0.8	-2.5
Net FDI (EUR bn)	6.2	3.3	1.4	1.5
FDI / Current Account (%)	75.8	103.6	480.9	160.0
FX Reserves (EUR bn)	12.7	12.9	13.0	13.5
Domestic Credit	**2008**	**2009**	**Q3 10**	**Q4 10**
Total Credit (%GDP)	75.2	79.2	78.7	76.3
Credit to Enterprises (%GDP)	47.8	49.4	49.4	48.2
Credit to Households (%GDP)	26.0	28.2	27.4	26.3
FX Credit/Total Credit (%)	57.2	58.6	60.9	61.3
Private Sector Credit (yoy)	32.3	4.5	2.7	2.1
Loans to Deposits (%)	119.3	120.5	116.0	112.9
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate		Currency Board		
EUR/BGN	1.96	1.96	1.96	1.96

Source: National Sources, Eurostat, IMF, Eurobank Research

All in, we estimate that the pattern of growth witnessed over the first three quarters of last year to have largely repeated itself in Q4. However, domestic demand turned out to be less weak while net exports performance was less robust compared to other quarters. As a result, the positive contribution of net exports declined from 8.8pps in Q3 to 1.6pps in Q4 (Figure 1).

Looking ahead, high-frequency indicators point to a continuation in industrial sector's recovery in the first quarter of 2011. Industrial production grew by 6.7% yoy in December bringing the corresponding full-year growth reading to 2% yoy, from -18.3% yoy in 2009. Industrial sales, a leading indicator of industrial production, were up 25.7% yoy in the last two months of 2010.

Figure 1: Net exports contribution to GDP growth declined in Q4



Source: National Statistics, Eurobank Research

The Q4 robust output reading brought full-year GDP growth into positive territory. GDP growth came at 0.3% yoy in 2010 compared with a 5.0% yoy contraction in 2009. The 2010 full-year outcome is lower than the 0.7% yoy initial government forecast, but marginally higher than our earlier forecast for flat growth. We expect growth to accelerate to 2.5% yoy or more in 2011, assisted by a sustained exports recovery and improving domestic-demand dynamics. However, we still see a number of downside risks to our forecasts. Firstly, this remains a jobless recovery, particularly in the non-tradable sectors such as services. According to Eurostat data, Bulgaria's unemployment was 10.1% in January (vs. 9.78% according to local statistics), still remaining on a rising trend. As a result, domestic households remain extremely cautious on their spending decisions, continuing to repair their balance sheets. Secondly, there are significant downside risks stemming from a relatively high private-sector external indebtness, in an environment characterized by lingering market worries over a number of debt-laden EMU economies. The external private sector stood at high levels, 89.4% of GDP in 2010 vs. 96% of GDP in 2009. Thirdly, NPLs are still on a rising trend, posting a further rise to 11.9% in Dec 2010, from 10.6% in September 2010.

Government says not planning a Eurobond issue this year

As we had alluded in our previous New Europe: Economics & Strategy issue, last year's better-than-expected budget execution allowed for greater flexibility with respect to government financing. According to preliminary results, the 2010 full-year cash budget deficit came at BGN 2.78 bn or 3.9% of projected GDP, compared to a deficit of 0.9% of GDP in 2009. The outcome turned out to be significantly lower than a revised deficit target of 4.8% of GDP.

The government financed the 2010 fiscal deficit by a) drawing down on its fiscal reserve account with the currency board arrangement (it was cut down to BGN 6 bn from BGN 7.6 bn in 2009) and b) issuing domestic debt. For this year, the Ministry of Finance has announced that it intends to issue less domestic debt i.e., some BGN 1bn, vs. BGN 1.5 bn in 2010. In addition, the government earlier announced plans to issue up to €1 bn in Eurobonds to finance part of the fiscal deficit. However, in anticipation of a lower than expected financing requirement, Deputy Prime Minister Symeon Djankov was recently quoted in Bloomberg as saying that Bulgaria will not issue a Eurobond this year because this is not deemed necessary.

EU progress report acknowledges partial progress in the areas of judicial reform and the fight against organized crime.

The European Commission issued in mid February its semi-annual progress report on judicial reform and the fight against organized crime in Bulgaria. The report takes note of the continued commitment to implement reforms in those areas and acknowledges the specific measures taken (i.e. amendments to the Judicial Systems Act, the establishment of specialized court and prosecution office for cases related to organized crime). However, the report called for the momentum of reform to be maintained, through further reform of the judicial system and of the police.

In our view, the present report constitutes a small, yet still significant, step towards further European integration. In the past reports, Bulgaria faced significant criticism, which led to the partial loss of pre-accession EU funds in 2008 (€ 220 mn from PHARE funds). Making more visible progress in the above mentioned areas is an absolute necessity. Firstly, weaknesses do not allow Bulgarian citizens to exercise their full rights as EU citizens. For that reason, France and Germany blocked Romania and Bulgaria's bid to be accepted into the passport-free Schengen zone in early 2011. More importantly, Bulgaria risks losing EU structural funds which are necessary for the development of the country. We will be looking for more progress on these issues in the next report to be published in the summer of 2011.

Written by:
Ioannis Gkionis
Research Economist
Coordinator of Macro Research
igkionis@eurobank.gr

II. New Europe – Country Analysis: **Poland**

Policy rate left unchanged in March; room for further NBP tightening ahead

- Q4-10 GDP growth accelerated to 4.4% yoy, from 4.2% yoy in the prior quarter. On a quarter-on-quarter basis, growth slowed to 0.8%, from 1.2% in Q3-10
- National Bank of Poland kept its key policy rate unchanged to 3.75% in early March; additional policy tightening expected ahead
- Inflation surge to 3.8% yoy in January on the back of higher VAT rates, rising food and energy prices
- Current account deficit in 2010 almost doubled from a year earlier as faster economic growth boosted demand

Q4-10 GDP growth accelerated to 4.4% yoy; from 4.2% yoy in the prior quarter

According to preliminary estimates, full-year real GDP growth in 2010 was 3.8% comparing to 1.7% a year earlier. In the last quarter of 2010, economic activity accelerated by 4.4% yoy compared to 4.2% yoy in the prior quarter. On a quarter-on-quarter basis, Q4-10 GDP decelerated to 0.8% qoq from 1.2% qoq in Q3-10 as a result of continued weakness in investment spending. The breakdown shows that domestic demand remained the key driver of growth with final consumption providing the main engine behind the strength of domestic demand. Government consumption rose by 1.4% qoq (5.4% yoy) in Q4-10, while private consumption slowed to 0.7% qoq (4.1% yoy) down from 1.1% qoq in Q3-10. On a less positive note, fixed investment stagnated on the quarter. This increase in consumption was supported by a rise in employment, accelerated growth in private sector wages and, quite probably, advance purchases by households in anticipation of a 1ppt VAT rate increase in January 2011. On the other hand, exports rebounded to 1.5% qoq (6.8% yoy) after a disappointing reading of -2.1% qoq (9.6% yoy) in Q3-10. A recovery in exports is an encouraging sign which indicates that third quarter's drop was more of a one-off event, rather than a beginning of a trend.

For 2010 as a whole, Poland's GDP growth was driven by domestic demand, predominantly private consumption. More precisely, domestic demand contribution to full-year growth was 5.6pp (private and public consumption: +3.2pp, gross capital formation: +2.4pp, investments: +0.3pp). On the other hand, the contribution of net exports was negative (-1.2pp).

Higher frequency data for the first two months of 2011 indicate a further acceleration in economic activity, albeit at a somewhat slower pace than in Q4-10. Namely, industrial production growth remained at double-digit levels for a third consecutive month (+10.2% yoy in January 2011 vs. 11.4% yoy in December). PMI manufacturing fell to 53.8 in February from 55.6 in January. In a similar mode, retail sales growth (in value terms) slowed to 5.8% yoy in January from 12.0% in December 2010, falling short of expectations for an 8.5% yoy gain. Yet, some short of slowdown in the retail sales was expected, given that a good volume of

Poland: Eurobank EFG Forecasts

	2008	2009	2010f	2011f
Real GDP (% yoy)	5.0	1.7	3.8	4.0
Private Consumption	5.8	2.3	3.2	3.5
Government Consumption	7.4	1.9	3.4	3.0
Gross Capital Formation	6.4	-13.8	6.3	6.5
Exports	7.3	-7.8	10.3	11.0
Imports	8.4	-13.5	10.8	11.2
Inflation (% yoy)				
CPI (annual average)	4.2	3.5	2.6	3.2
CPI (end of period)	3.3	3.5	3.1	2.8
Fiscal Accounts (% GDP)				
General Government Balance	-3.7	-7.2	-7.9	-7.0
Gross Public Debt	47.2	51.0	55.0	57.0
Labor Statistics (%)				
Unemployment Rate (% of labor force)	9.8	11.0	12.0	12.3
Wage Growth *(private sector - average)*	NA	4.2	3.6	5.0
External Accounts				
Current Account (% GDP)	-4.8	-2.2	-3.3	-3.5
Net FDI (bn EUR)	8.0	6.1	7.5	8.0
FDI / Current Account (%)	40.6	90.6	65	75
FX Reserves (bn EUR)	40.6	54.8	70	60
Domestic Credit	**2008**	**2009**	**Q3-10**	**Q4-10**
Total Credit (% GDP)	50.9	53.1	54.6	55.4
Credit to Enterprises (% GDP)	17.6	16.1	15.6	15.2
Credit to Households (% GDP)	29.7	31.6	33.6	34.2
FX Credit/Total Credit (%)	32.6	30.2	30.1	30.8
Private Sector Credit (% yoy)	38.1	7.2	7.6	8.9
Loans to Deposits (%)	106.0	102.6	102.0	102.4
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	3.75	4.00	4.25	4.50
EUR/PLN	3.97	3.90	4.00	3.90

Source: NBP, EcoWin, Bloomberg, Eurobank Research

purchases was brought forward ahead of January's VAT increase. Moreover, wage growth remained at a moderate level; it slowed to 5.0 % yoy in January 2011 down from 5.4% yoy recorded in the prior month. At the same time, employment growth accelerated to 3.9% in January 2011 up from 2.4% in the previous month. Yet, unemployment increased again, it stood at 13.0% in January 2011 from 12.3% in December 2010. The recent pick-up in employment appears to have been offset by an expansion in the overall workforce.

All in all, we anticipate growth in 2011 as a whole to stabilise at levels around 4.0%. However, quarterly real GDP growth is projected to ease in the first quarter as VAT increase and inflation pick-up are expected to temporarily hamper private consumption. But, strong public investment in infrastructure ahead of Euro 2012 football championships preparations will likely provide an offset.

Current account deficit up sharply in 2010 on strong domestic demand

Poland's current account deficit for the full year 2010 almost doubled from 2009 as faster economic growth boosted demand; it widened to €11.6bn, or 3.3% of GDP, up from €6.8bn in 2009. Similar to 2009, the largest contributor to the current account deficit came from the income deficit, at around 3.6% of GDP, reflecting profit remittances and dividend payments from foreign-owned companies. Trade gap also widened significantly, it reached €6.3bn in 2010 from €3.1bn in 2009 on the back of increased demand for imported goods and rising food and energy prices. What's more, FDI inflows fell to €7.5bn last year from €9.9bn in 2009, its lowest level in several years, partly due to lower reinvested earnings and inter-company lending. Overall, we anticipate the current account deficit to widen further to 3.5% of GDP in 2011 from 3.3% of GDP in 2010 on strong domestic demand.

January inflation overshoots NBP's comfort zone on higher VAT rates, surge in food and energy prices

In January 2011, headline inflation rose to 3.8% yoy, from 3.1% yoy in the prior month, exceeding expectations of a 3.4% yoy reading. This print lies above the NBP's inflation target zone of 2.5%±1%. The rise in CPI was largely the result of January's increase in VAT rates coupled with surge in food and energy prices. More precisely, food inflation rose to 4.8% yoy up from 1.5% yoy in December while dwelling (which includes housing, water, electricity, gas and other fuels) increased to 6.1% yoy from 2.6% yoy in December 2010. Even though January core inflation (measure which excludes food and energy prices) has yet to be released, we estimate it to have risen too from its levels in December. According to the President of NBP, Marek Belka, inflation may still rise further in H1-11 mostly due to supply-side shocks, but these should ease in the second half of the year. In our view, Polish inflation will most likely hover around the upper bound of central bank's inflation target of 3.5% in the first semester of 2011, reflecting rising commodity prices and improving domestic demand. Since this impact is expected to ease in H2-11, inflation will likely ease gradually thereafter, reaching an average of 3.2% yoy for the year as a whole.

NBP kept key policy rate unchanged in early March citing absence of convincing signs of a considerable recovery in investments; additional policy tightening expected ahead

The National Bank of Poland (NBP) initiated a tightening cycle in mid-January, hiking its key rate by 25bps to 3.75%. In early March, the NBP kept the interest rates unchanged, citing the absence of signs of considerable recovery in investments. What's more, at the press release it was stated that wage pressure in the corporate sector is still moderate while continuing rise in unemployment decreases the risk of inflation overshooting the 3.5% target in the medium term. Yet, the NBP left the door open for further interest rates hikes ahead. We expect the Monetary Policy Council (MPC) to continue tightening with the next hike materializing as soon as at April's MPC meeting. We expect the key policy rate to reach 4.5% at year-end.

Banking sector developments

According to the most recent NBP data, corporate credit decelerated by 0.5% yoy in January 2011 (vs. 0.9% yoy deceleration in December 2010 and -3.2% yoy in September 2010). Yet, it showed some signs of recovering by growing by 0.7% mom in January. On the other hand, household loans declined by 0.8% mom in January. Overall, total private sector credit decelerated by 0.4% mom in January 2011. More worrisome, Non Performing Loans (NPLs) to total loans kept rising reaching 8.5% in January from 8.3% in the previous month.

Written by

Dr Stella Kanellopoulou
Research Economist
Skanellopoulou@eurobank.gr

II. New Europe – Country Analysis: **Romania**

Romania: New two-year precautionary agreement is announced

- New IMF/EU precautionary agreement to replace present arrangement when it expires (April 2011)
- Inflation decelerates for the first time since last July; CPI falls to 7% yoy in January, from 8% yoy in the prior month
- Current account deficit was 4.2% of GDP in 2010, same as a year earlier

IMF completes final review of current agreement, announces € 5bn two-year precautionary agreement to replace existing facility

The IMF mission completed the seventh and last review of the current agreement which expires in May. With respect to the financing part of the agreement, the government has so far made use of €12.5 bn of IMF funding and €3.7 bn funds from the EU. Upon approval by the Fund's Board, the country will gain access to the eighth tranche of €913.2 mn. However, the government has stated that it will make no use of the last two tranches (seventh and eighth).

The assessment of the mission was that all quantitative criteria were met with the exception of government arrears. The latter has proved out to be a contentious issue in the implementation of the IMF program. It is worth noting that this performance criterion was never met since the inception of the program, so that a waiver has been granted until its termination. The government has attempted to address the issue with limited success so far. It is worth nothing that according to high-level IMF official in Romania, accumulated arrears of state-run enterprises stood at 5% of GDP at the end of last year. This is huge by any comparison, given that the consolidated government deficit on a cash basis was 6.5% of GDP in 2010 down from 7.4% of GDP in 2009. In our view, the high level of arrears undermines not only the fiscal consolidation effort of the government but also hinders domestic economic growth, as the unpaid bills to contractors deprive the private sector of invaluable resources, constraining future consumption and investment decisions.

More importantly, IMF announced that it has reached an agreement with the government on a new precautionary agreement to succeed the existing Stand by Arrangement. The new agreement envisages total funding of €5bn (€1.4bn from EU and €3.6bn from IMF). A new € 0.4 bn loan from World Bank has been secured as well. According to the IMF statement, the new agreement will focus on promoting growth and employment, while maintaining domestic macroeconomic stability. Furthermore, the government will undertake the commitment to implement further structural reforms in the areas of tax collection, EU funds absorption, the liberalization of energy prices and the privatization of state owned enterprises in transportation and energy sectors.

Romania: Eurobank EFG Forecasts

	2008	2009	2010	2011f
Real GDP (yoy%)	7.3	-7.1	-1.3	1.5
Private Consumption	9.5	-10.5	-2.1	1.0
Govern. Consumption	7.1	0.8	-3.9	-2.5
Gross Capital Formation	16.2	-25.3	-14.1	3.5
Exports	8.7	-5.5	13.1	7.5
Imports	7.8	-20.6	11.6	5.0
Inflation (yoy%)				
CPI (annual average)	7.9	5.6	6.1	5.5
CPI (end of period)	6.3	4.7	8.0	4.5
Fiscal Accounts (%GDP)				
General Government Balance (ESA 95)	-5.4	-8.3	-7.3	-4.9
Gross Public Debt (ESA 95)	13.4	23.9	35.5	40.0
Labor Statistics (annual avg,%)				
Unemployment Rate (% of labor force)	4.0	6.3	7.8	7.0
Wage Growth (total economy)	23.6	8.4	2.0	1.4
External Accounts				
Current Account (%GDP)	-11.6	-4.4	-4.2	-6.0
Net FDI (EUR bn)	9.3	3.5	2.4	3.5
FDI / Current Account (%)	57.7	72.2	57.6	65.0
FX Reserves (EUR bn)	26.2	28.3	32.4	38.0
Domestic Credit *(end of period)*	**2008**	**2009**	**Q3 10**	**Q4 10**
Total Credit (%GDP)	42.7	50.2	52.4	52.7
Credit to Enterprises (%GDP)	18.8	19.6	20.5	20.4
Credit to Households (%GDP)	19.7	20.4	20.5	19.9
FX Credit/Total Credit (%, private)	53.1	60.1	62.5	63.0
Private Sector Credit (yoy)	33.7	0.9	4.5	4.7
Loans to Deposits (%)	131.9	130.6	134.8	137.7
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	6.25	6.25	5.75	5.50
EUR/RON	4.20	4.25	4.30	4.30

Source: National Sources, Eurostat, IMF, Eurobank Research & Forecasting

As we had alluded in our previous New Europe Economics & Strategy issue, the duration of the new agreement was a focal point of negotiation with the Fund. Finally, the choice of two years for the length of the agreement met the expectations of market participants. From a timing perspective, the duration of the new agreement will surpass the political cycle and minimize the cost of fiscal slippage ahead of the parliamentary elections which are scheduled for late 2012. Furthermore, the new deal will be binding for the next government who will need to maintain the same set of policies in place.

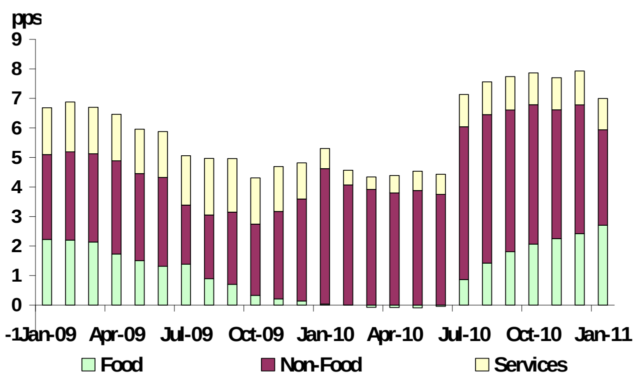
Having reached a peak last December, inflation is seen decelerating in the following months

Consumer price inflation came at +0.8%/+7% mom/yoy in January 2011. This was slightly higher than the market's median forecast (+0.6% mom/+6.8% yoy), but lower than +0.5%/8% mom/yoy a month earlier. In EU-harmonized terms, HICP inflation rose to 6.2% yoy in January, from 6.1% yoy in December. This was the highest inflation reading in the EU-27 for the sixth consecutive month.

On the positive side, the January headline CPI rate was influenced by favorable base effects, stemming from a hike in tobacco excise duties that went into effect in same month a year earlier. Yet, higher food and fuel prices had an adverse impact. Food prices (+1.1% mom/+7.2% yoy) were one of the main culprits, driven by surging prices of vegetables (+5.6% mom/+27.6% yoy) and fresh fruit (+2.7% mom/+18% yoy). Non food prices were also higher in January (+0.8% mom/+7.2% yoy), driven by accelerating prices of fuels (+2.2% mom/+15.4% yoy) and thermal energy (+3.2% mom+11.9% yoy). In contrast, services prices declined moderately (-0.1% mom/+5.9% yoy), assisted by the leu's appreciation trend in January 2011.

The 5ppts VAT hike in July 2010 (from 19% to 24%) aggravated inflationary pressures in recent months, driving inflation to 8% yoy in December, from 4.4% yoy in June. Rising concerns about second-round price effects from the VAT hike prompted the Central Bank to temporarily discontinue its interest rates easing cycle last spring (key policy rate currently at 6.25%). On a more positive side, initial worries over second-round effects do not seem to have materialized so far. For instance, adjusted Core 2 inflation (CPI excluding regulated prices, fresh food, tobacco and alcohol) remains relatively subdued (4% yoy), reflecting weak demand pressures.

Figure 1: Inflation is rising on higher food prices in recent months



Source: National Statistics, Eurobank Research

In our view, headline inflation has likely peaked last December. Disinflation is expected to resume in the following months and gain momentum in H2-2011, when the impact of last year's VAT hike falls out of the equation. According to our forecasts, annual inflation is set to end this year between 4.0% and 4.5%, marginally above the upper boundary of the 3%+/-1% official target. In its latest Inflation Report, the Central Bank revised its end-2011 CPI projection to 3.6% yoy, from 3.4% yoy, previously. We see some upside risks to that forecast, stemming from supply side factors such as the ongoing rally in food and fuel costs and further increases in the administered prices. Barring any unforeseen external shocks, we see room for the Central Bank to resume its easing cycle, bringing its key policy rate to 5.25%-5.50% at the end of 2011, from 6.25% currently.

2010 full-year current account deficit at 4.2% of GDP, lower than analysts' expectations

The deterioration in current account deficit last year proved milder than analysts' expectations. Following a 50% yoy widening in the external deficit in H1, the current account shrunk by 45% yoy in the second half of last year, thanks to lower imports as a result of the government's aggressive fiscal consolidation package. As a result, the 2010 current account deficit inched up to €5.2bn against €4.9bn. in ppts-of-GDP terms, the deficit reached 4.2% last year, same as in 2010 and down from 11.6% of GDP in 2008. On the financing side, net FDI inflows plunged by 25.6% yoy to €2.6bn (3.1% of GDP) in 2010, covering 50.3% the current account shortfall compared to 70.9% in 2009.

The good news is that trade dynamics continued to improve in 2010. Exports posted an extraordinary rebound (+28.1% yoy), assisted by the economic recovery in the euro area where the majority of exports is heading to as well as a weaker leu. On top of these developments, another interesting trend is currently taking place; exports to non EU markets are expanded more rapidly (+38.7% yoy), benefiting from the increasing penetration in the markets of Russia and Turkey. In contrast, imports grew by 19.9% yoy in 2010. The revival of imports is closely tied to the rebound in exports as the domestic demand remains in negative territory. A large part of imported materials is used as inputs for exported goods because of insufficient domestic industrial capacity.

The balance of services recorded a €750mn deficit in 2010, which was 2.6 times higher than in 2009. This was the combined result of lower tourist receipts (the deficit of the respective component was doubled) and transportation fees relative to the same period a year earlier. The bad news is that the current transfers' surplus, an item which traditionally reduced the deficit, declined by 17.9% yoy last year. Declining remittances from Romanian worker abroad and low EU funds' absorption was the main culprit behind the latter development.

Written by

Ioannis Gkionis
Research Economist
Coordinator of Macro Research
igkionis@eurobank.gr

Special Focus - Romania

Focus-Romania

The end of recession is in sight…

Romania's real GDP contracted by 1.3% YoY in 2010, less than our forecast of -1.8% and market expectations (-2.0% in the Thomson Reuters poll). On seasonally adjusted data, the GDP grew by 0.1% QoQ in Q4 2010. The news is positive, suggesting that the economy is about to bottom out.

When accounting for price changes, only two economic branches added more value in 2010 than in 2009: industry (+5.1% YoY, driven by external demand) and financial services (+0.8% YoY, on improved efficiency). Together, they generated 40.3% of 2010 nominal GDP. Constructions and market services (the latter including retail) contracted 10.8% and 4.1% YoY respectively (using comparable prices). Their aggregate reduction compensated the gains made by industry and financial services (constructions and market services generated 33.8% of nominal GDP in 2010), thus sending the economy into a second successive year of recession.

Private consumption (measured in constant prices) shrank 1.8% YoY in 2010 and 1.5% in Q4 2010 vs. Q4 2009. The reasons were falling real revenues and consumer loans, consumer pessimism and high unemployment (on average, there were 694,000 registered unemployed people during each month of 2010, 120,000 more than in 2009). Real gross fixed capital formation dropped 13.1% YoY in 2010 (the fall was 4.7% Q4 2010/ Q4 2009). Private sector investments were crowded out by the government's financing needs. Exports and imports rose 14.3% and 12.4% YoY respectively on high demand for Romanian manufactured products (which incorporate a sizeable amount of imported materials and intermediate goods).

… but economic data still calls for caution

Exiting the recession is often described as two consecutive quarters of (seasonally adjusted) real GDP growth. The National Bureau of Economic Research, the official tracker of recessions in the US, has a more nuanced definition for recessions: "a significant decline in economic activity spread across the country, lasting more than a few months, normally visible in real GDP growth, real personal income, employment (non-farm payrolls), industrial production, and wholesale-retail sales."

Based on the aforementioned criteria and on other high frequency data, we still expect the economic recovery to happen around mid-year 2011, i.e., a quarter later than the Government and the IMF

A. Inconclusive GDP recovery

The seasonally-adjusted, quarterly GDP growth rate of 0.1% posted in Q4 2010 is insufficient to call for an outright economic recovery. It is likely that it will be revised to a contraction once 2011 data will be available (the seasonally adjusted series is an unobserved series and has to be filtered from the observed data. All data filtering methods are subject to end-point problems). Nevertheless, quarterly dynamics show the dip is nearing the end.

B. Wages, pensions and remittances to grow in 2011 after declining in 2010 vs. 2009

1. The average real wage has decreased by 4% YoY in 2010 and by 1.6% in Q4 2010 over Q3 2010 (seasonally adjusted data);
2. The new pension law has trimmed down higher pensions and social security benefits. In 2010, social security expenditure shrank by 0.7% YoY when adjusted for inflation;
3. Remittances have fallen from their historical maximum of 6.6 billion euros in 2008 to 4.4 billion euros in 2009 and just 3.8 billion euros in 2010.

Leading indicators:

Positive: The spectre of general elections in 2012 will probably drive public sector wages and pensions higher during 2011. In January 2011, public sector wages have already risen by 15% compared to their October 2010 level. They were cut by 25% on 1 July 2010 (the law implementing wage reductions mentioned the cuts were temporary);

Positive: Italy and Spain look to be exiting recession, meaning remittances could bottom out in early 2011.

C. Strong performance in industry

Industrial production was first hit by the international recession in Q1 2009. By Q1 2010, YoY growth resumed, driven by exports. In 2010, industrial production was 0.3% lower in real terms than at its peak in 2008, but 5.5% higher than in 2009. Annual exports valued in euro shrank by 5.9% in 2010 from the 2008 high, but grew 14.5% YoY from the 2009 trough.

Leading indicators:

Positive: the European Commission (EC) survey shows expectations regarding export orders, employment, production trends and competitive position on foreign markets just below the levels of October 2008, before industrial production collapsed;

Positive: foreign demand for Romanian manufactured goods is increasing, as shown by the volume of foreign orders (+40.2% YoY in 2010) and by the improvement of export order books, according to the EC survey.

D. Weakening retail sales in 2010, strong expectations in 2011

Retail sales fell by 5.3% in 2010 vs. 2009. Their fall decelerated through H1 2010 (from -12.4% YoY in January 2010 to +4.6% YoY in June 2010), only to gather speed again in H2 2010 (-9.0% YoY in December 2010). The culprits were tightening fiscal measures (public wage cuts and VAT hike). Throughout 2010 and the first two months of 2011, the EC survey constantly recorded inventories as being slightly higher than the adequate level, meaning wholesale and retail sales have been falling at a similar pace.

Leading indicators:

Negative: consumer pessimism is historically very persistent. 73% of consumers surveyed by the EC in February 2011 were pessimistic, down from 81% in July 2010 (when fiscal reforms were implemented), but up from 56% in September 2008. Moreover, just 20-25% of consumers surveyed between June 2010 and February 2011 had the intention to make major purchases over the next 12 months. Potential reasons:

1. wage and pension cuts;
2. falling consumer lending (-4.8% YoY in 2010, euro equivalent);
3. negative wealth effect from lower asset prices: the majority of banks surveyed by the NBR in January 2011 were expecting Q1 2011 to be the 11th consecutive quarter of falling home prices. Faced with a negative net worth, many households sacrifice major purchases;

Positive: consumer pessimism is appeased by the perspective of higher revenues in 2011 and by falling unemployment. The unemployment rate declined from a seven-year high of 8.36% in March 2010 to 6.74% in January 2011, a 17-month low;

Positive: February 2011 PMI for retail and services improved dramatically, to levels last seen in January 2009 (optimistic views came from 51% and 53% of respondents respectively, still down from 62% and 64% respectively in H1 2008, at the pinnacle of the boom).

E. Financial intermediation to improve further

1. The credit risk ratio (the ratio of loans and interest classified "doubtful" and "loss" to total loans granted to non-banking clients plus corresponding interest) ? has stabilised below 21% in Q4 2010 and the NBR expects it to decline in 2011.
2. Lending has resumed in 2010 (+3.4% YoY in December 2010, euro equivalent), the main recipients being companies (+7.7% YoY in December 2010, euro equivalent) and mortgage buyers (+17.8% YoY in December 2010, euro equivalent), the latter supported by state guarantees expected to be extended in 2011. The selective rise in lending is expected to continue in 2011 along the same lines.
3. At the end of 2010, the private sector held the equivalent of 2 billion euros in additional deposits compared to December 2009 (a 4.7% YoY increase). Capital outflows and crowding out by the government left the private sector with a surplus of 3.7 billion euros in 2009 and 2.8 billion euros in 2010. Households added the equivalent of 1.14 billion euros in deposits. Attractive interest rates drove households to switch from demand deposits to time deposits, while firms chose to divide money between the two types of deposits.

F. Meagre foreign investments unable to help the economy out of recession

1. Foreign direct investment in Romania peaked at 9.5 billion euros in 2008, but plunged to just 3.5 billion euros in 2009 and 2.6 billion euros in 2010 (comparable to levels last seen between 2000 and 2003, when Romania was not a member of NATO or the EU). In September 2009, the United Nations Conference on Trade and Development (UNCTAD) estimated world FDI flows at 1.114 trillion USD for 2009 and 1.122 trillion USD for 2010 (an increase of 0.7% vs. 2009, but a decrease of 46.6% vs. the all-time high in 2007). Among the possible explanations for Romania's incapacity to keep pace with international FDI flows are:

   a. The failure to exit recession, as opposed to most emerging markets;

b. Unquenched risk aversion towards Central and East European countries and investors' demand for liquid financial markets in case of a rapid exit;

c. Red tape and the failure of the political class to decisively simplify the fiscal code: between 2009 and 2011, Romania slipped 11 places to 56 in the world ranking of most attractive investment destinations according to the Doing Business project of the International Financial Corporation. It lost ground in all categories but property registration and closing businesses;

d. Poor infrastructure.

No rapid improvements on all aforementioned hindrances can be foreseen at present, so we expect FDI inflows to be at most 4 billion euros in 2011, below official and market expectations of 5 billion euros.

2. Capital flows to Romania excluding FDI and tranches from the IMF and the EC totalled just 244 million euros in 2010 (outflows amounted to 5.5 billion euros in 2009, according to NBR data).

G. Huge productivity differentials make employment an unreliable indicator of the business cycle position of the Romanian economy

1. According to Eurostat data, the number of people employed by industrial firms in December 2010 was just 49.3% of what it used to be in January 1998. A similar decline was registered by the number of employees in manufacturing (-50.5% in December 2010 vs. January 1998). Meanwhile, imported technology allowed for an increase in the volume of production by 61.3% throughout the same time interval (and thus for productivity gains).

2. The number of employees in services peaked in January 2009 (24.4% higher than in January 1998), subsequently declining 13.6% until November 2010.

3. The seasonally adjusted employment figure for construction was highest in March 2008 (1.5% higher than in January 1998), but dropped by a third until December 2010.

All the aforementioned employment measures show no sign of bottoming out. One cause could be the potential for further productivity gains. Other explanations are the steady increase of the underground economy and of the number of workers migrating abroad.

Leading indicators:

Positive: employment expectations in the February 2011 EC survey in industry are highest on record (since January 1992);

Positive: in February 2011, employment expectations in construction were back at levels last seen at the end of 2008 (the sector peaked in March 2009);

Positive: employment expectations in retail and services surged in February 2011 back to where they stood at the beginning of 2009.

Potential risks: limited downward moves for the exchange rate and interest rates because of the slow exit from recession

1. EURRON could climb back in the 4.25 – 4.3 RON/EUR interval:

   a. in Q2 2011, if the market is negatively surprised after pricing in the end of recession in Q1 2011;

   b. in H2 2011 and Q1 2012, if the recovery proves too slow (the IMF expects the economy to grow by 3.5% YoY in 2012; our forecast is just 1.5%);

2. Money market interest rates could stay above 5% for maturities longer than 3 months if:

   a. the bulk of FX inflows comes from International Financial Institutions rather than private investors;

   b. treasury yields could remain over 6.5% up to one year and over 7% for longer tenors if the MoF misses its revenue targets because of slower growth and too optimistic budget planning.

Written by:

Dan Bucşa
Head of Research
Global Markets, Bancpost S.A.
Dan.Bucsa@bancpost.ro

II. New Europe – Country Analysis: **Serbia**

Serbia: Domestic political noise on the rise

- The resignation of Deputy Prime Minister and Minister of Economy Mladan Dinkic increases worries over the stability of the present coalition government, which term expires in mid 2012
- The Central Bank left its key policy rate unchanged at 12.00% on February 12, but maintained its tightening bias
- The government is wrapping up discussions with the IMF over a new (precautionary) arrangement

Sharp rise of domestic political noise leads to a cabinet reshuffle

On February 14, Prime Minister Mirko Cvetkovic dismissed Deputy Prime Minister and Minister of Economy & Regional Development Mladjan Dinkic. The starting point of the recent political turmoil was a public dispute between Mr. Dinkic and Finance Ministry State Secretary Slobodan Ilić over a capital investment project. The dispute culminated in the former sending a letter to the Prime Minister requesting the replacement of the State Secretary. In that letter, Mr. Dinkic demanded that Mr. Ilić be "penalized most severely" for his "cowardly" comments. This incident increased dramatically the tensions among the ruling coalition partners, leading Mr. Dinkic to claim publicly that centers outside the government exercised control over the cabinet.

Following Mr Dinkic's public criticism over the cabinet's independence, the Prime Minister moved on to replace him. In response, Mr. Dinkic submitted his resignation, making it easier for the Parliament to approve his replacement. Despite initial speculation to the opposite, he also stressed that his resignation was not intended to withdraw parliamentary support from the government. This is important, because Mr Dinkic is also the head of G17 plus, one of the coalition partners, upon which the current government relies to maintain majority in parliament. Indeed, the resignation didn't translate to a withdrawal of G17 plus support to the government coalition, thus preventing an early election.

However, two other ministers nominated by G17 plus resigned as well. On February 21st, the parliament accepted the resignations of the following G17 plus-backed ministers: Deputy PM and economy minister Mladjan Dinkic, the minister for National Investment Plan (NIP) Verica Kalanovic and health minister Tomica Milosavljevic. At the time of the writing, only temporary replacements had been announced.

In our view, the aforementioned developments may entail some serious implications for the domestic political and economic landscape. First of all, the resignations may harm the government's efficiency, given that Mr. Dinkic has held the post of Minister of Economy ever since the formation of the present coalition (July 2008) and his influence is undisputable. Secondly, the resignations reduce the government's political capital and decrease its bargaining power vs. the public sector unions. The later may become more apparent as the next elections date is coming closer (the last parliamentary elections took place on May 8, 2008). Note that the government is already in a collision course with teachers who are on strike asking for higher wages.

Secondly, the resignations risk to severely affecting the functioning of the cabinet. Tensions within a fragmented government coalition consisting of several parties were already high. From that point of view, the stance of G17plus regarding parliamentary approval of the new ministerial appointments has became more rigid. In turn, this sends a clear message: either the coalition functions on a true partnership basis, or there is no coalition at all.

Serbia: Eurobank EFG Forecasts

	2008	2009	2010	2011f
Real GDP (yoy%)	5.5	-3.0	1.7	3.0
Inflation (yoy%)				
CPI (annual average)	12.5	8.2	6.5	9.0
CPI (end of period)	8.6	6.6	10.3	6.0
Fiscal Accounts (%GDP)				
General Government Balance	-2.6	-4.2	-4.4	-4.0
Gross Public Debt	25.6	31.3	41.5	45.0
Labor Statistics (%)				
Unemployment Rate (%of labor force, ILO)	14.7	16.1	19.2	18.0
Wage Growth *(total economy)*	17.9	4.1	4.6	8.3
External Accounts				
Current Account (% GDP)	-17.6	-6.9	-7.0	-9.0
Net FDI (EUR bn)	1.8	1.4	0.8	2.0
FDI / Current Account (%)	30.0	78.7	38.5	70.0
FX Reserves (EUR bn)	8.2	10.6	10.0	11.5
Domestic Credit	**2008**	**2009**	**Q3 10**	**Q4 10**
Total Credit (%GDP)	41.0	48.7	57.0	59.9
Credit to Enterprises (%GDP)	25.8	29.4	33.4	34.9
Credit to Households (%GDP)	14.0	14.7	16.9	17.1
Private Sector Credit (yoy)	34.9	14.3	26.5	26.5
Loans to Deposits (%)	125.1	127.0	141.6	144.6
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	12.00	13.00	12.50	10.00
EUR/RSD	103.92	100.00	100.00	105.00

Source: National Sources, IMF, Eurobank Research & Forecasting

Last but not least, the resignations increase the chances that the current government coalition may not be in a position complete its full term, which expires in mid 2012. Note here that it was the G17 party that brought down the cabinet of PM Vojislav Koštunica back in October 2006, which eventually led to early parliamentary elections. Although a full-blown political crisis has been averted for now, domestic political risks are certainly more elevated given the vital role of G17 plus party's support for the government coalition. Note that the ruling government coalition holds 129 seats (in the 250-seats parliament), with 24 of them being currently controlled by G17 plus. That said, although the risk of bringing down the government is not imminent, the countdown to the next parliamentary elections may have already began.

Government wrapping up discussions with the IMF over a new precautionary arrangement

On February 22, the government and the IMF mission reached agreement over the seventh and last review of the existing support program. The IMF mission assessed that the program is performing satisfactorily across all areas. All of the main quantitative targets, including that of the fiscal deficit, were met by a wide margin at the end December 2010. In contrast, inflation exceeded the upper limit by 2.25 pps in line with expectations.

Discussions focused on the attainability of this year's fiscal target. This is an issue of high importance for both domestic inflation and fiscal stability, as 2011 will be the first year since 2009) to see a nominal rise in public wages and pensions. The government succeeded in bringing forward by three months to early 2011 the implementation of an unfreezing of public wages and pensions. The modified agreement now foresees that indexation should take place three times a year (January, April and October). The first indexation would be based on the use of inflation only. The second will take into account the GDP performance in the last year. The third will be based on the previous six-month average inflation. The 1st installment of the indexation of wages and pensions was limited to 2% in Jan 2011. However, that decision by itself spurred a tsunami of public-sector union demands (police, teachers unions) for wage increases above the IMF-agreed levels.

With respect to the financing part of the agreement, the government will gain access to another tranche of €335mn upon approval of the seventh review by the IMF Board. However, the government has so far made use of only €1.5bn out of total funds of €2.9bn available under the present program. After drawing some €56 mn from the June 2010 tranche, the government stated that will no make use of the last two program tranches.

In conclusion, the current IMF program is running smoothly towards its conclusion. A new precautionary agreement is the most probable scenario in the foreseeable future. The duration of the new agreement remains an unknown parameter that could well prove a politically-sensitive topic, given that its implementation may be binding for the next government. It is widely expected that the new agreement will envisage elements of further reform in the public sector with a special focus on public enterprises and the pension system.

In our view, a new precautionary agreement will not only serve the purpose of shielding the country from a potential new crisis. More importantly, it will bolster investors' sentiment by providing an anchor for fiscal policy and a catalyst for further structural reforms. Let's not forget that, the leadership of Serbia was proactive enough to ask for a precautionary agreement with IMF. Indeed, Serbia was the first country in the SEE region to run a €0.5 bn precautionary agreement in November 2008 which turned into a regular in January 2009.

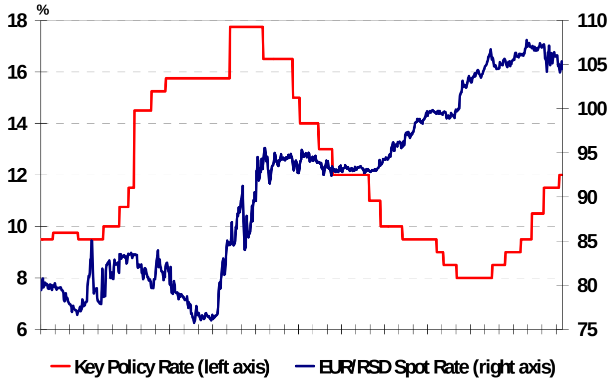
Central Bank leaves key policy rate at 12.00%; dinar rebounds

On February 12t, the Central Bank left interest rates unchanged at 12.00%. This was the first pause in the monetary policy tightening cycle that started in early August 2010. The Central Bank has delivered 400bps of cumulative rate hikes since then in an attempt to combat domestic inflationary pressures and stabilize the dinar. According to a Bloomberg survey conducted ahead of the last policy meeting, 16 out of the 21 economists expected no rate change, 4 expected a 50bps hike and one expected a 50bps cut.

In our view, there were two important factors that weighed on the NBS's wait-and-see policy decision. First of all, the Bank's aim to prevent inflation expectations from triggering a second round of price increases appears to have been achieved. Indeed, in the NBS's new Inflation Report published in late February, evidence from the Gallup, Bloomberg surveys was presented to confirm that this aim has been accomplished. Furthermore, it was explicitly mentioned that the Central Bank maintained its tightening bias.

Secondly, there has lately been strong demand from local banks and foreign investors to invest in local government paper and other dinar-denominated assets. Notably, the most recent euro- and dinar-denominated debt issues were absorbed easily by the market. The first €200 mn euro-denominated 1Y-Tbill issue on February 9 was 5.1 times oversubscribed, resulting to an average weighted yield of 4.84%. In the FX market, the dinar recouped some of its earlier losses in early 2011, strengthening to 103.3/€ on February 25, compared to 105.9/€ at the end of last year and a historic low of 108.1/€ recorded on October 28. Looking ahead, we expect foreign investor demand for high-yielding domestic paper and the Central Bank's tightening bias to allow the local currency hit levels below 100/€ over the next three months.

Figure 1: Domestic currency has recouped some of its losses in Jan-Feb 2011



Source: Bloomberg, Eurobank Research

On the other hand, there is a good chance that we may have not yet seen the peak of key policy rates, even though the Central Bank stated in its January policy meeting that it would rely less on interest rates hikes going forward.

On the inflation front, headline CPI accelerated in January, deviating further from the upper boundary of the Central Bank's target band in January (6%+/-2%). The tolerance band is defined for each month so that the Central Bank monitors the target throughout the year (the year end inflation target stands at 4.5% +/- 1.5%). Consumer prices came at 11.2% YoY in January, compared to +10.3%YoY in last December and 6.7% YoY in last July. According to the latest NBS projections, domestic inflation is expected to continue fluctuating within the10%-14.5% range in 1H 2011, reaching its peak in late Q1 or early Q2. In our view, disinflation will resume in the second half of this year, assisted by favorable base effects. We forecast year-end CPI at around 6% yoy.

Written by

Ioannis Gkionis
Research Economist
Coordinator of Macro Research
igkionis@eurobank.gr

II. New Europe – Country Analysis: **Turkey**

Strong growth momentum likely to be maintained throughout Q1:2011

- Rising oil prices primary risk stemming from the unrest in Middle East
- Annual headline CPI falls to a new 4-decade low in February
- January's widening
- Wider trade deficit in January suggests strong imports growth continues

Strong growth momentum to be maintained throughout Q1:2011

Though official data for Q4 GDP have yet to be released (due at the end-March), we estimate the Turkish economy to have grown by 5.5%yoy in real terms in the last quarter of 2010. If our estimates are vindicated, then full-year growth came in at ca 8.0% in 2010, i.e., slightly stronger than consensus (+7.6% according to the latest Bloomberg survey). Meanwhile, a recent flurry of high-frequency activity and survey data suggest that the strong economic momentum continued in the first two months of this year. Among others, industrial output grew by 16.91%yoy in December, marking its sharpest annual pace of increase since April. In seasonally adjusted terms, the index grew by its highest monthly rate on record, signaling that the output gap may be closing faster than expected previously. In a similar tone, the manufacturing PMI index came in at 58.5 in February, indicating that the sector is expanding at its fastest pace since the survey began in mid-2005. The breakdown of the PMI report revealed that both output and new orders surged to lifetime highs. On a less positive note, the capacity utilization index fell for the third month running in February to 73.0%. Nevertheless, it stands just 2.9ppts off November's 2-year high. Moreover, confidence in the manufacturing sector remains strong, with the corresponding index remaining in February close to a 9-month peak recorded in the prior month. According to the most recent data from the Banking Regulation and Supervision Agency, consumer loans grew by 39.4%yoy in January, the fastest pace since August 2008. Also pointing to strong domestic demand dynamics, the consumer confidence index hit 91.29 in January, remained within distance from a 3-year high marked late last year. In a similar vein, labor market conditions continue to improve with the rate of unemployment moderating for the third month running in November to 11.0%. External demand is also revealing signs of strengthening. Importantly, the number of foreign visitors soared by 20.46%yoy in January after a 4.91%yoy decline in December. Exports rose by 22.1%yoy in the first month of the year, following a rise of ca 11%yoy in Q4. According to the Turkish Exporters' Assembly (TIM), exports growth gained pace in February, rising by 24.2%yoy to $10.2bn. Along these lines, we expect growth of around 5.5%yoy in Q1:2011. For the full-year, we maintain our 5% GDP growth projection. The slowdown relative to last year is anticipated on the back of base effects, the ongoing negative contribution from net exports and tightening monetary conditions. We expect domestic demand to remain the primary driver of growth this year as credit expansion remains strong and labor market conditions continue to improve.

Turkey: Eurobank EFG Forecasts

	2008	2009	2010F	2011F
Real GDP (yoy%)	0.7	-4.7	8.0	5.0
Private Consumption	-0.3	-2.3	6.4	4.5
Govern. Consumption	1.7	7.8	3.2	3.5
Gross Capital Formation	-6.2	-19.2	24.0	13.0
Exports	2.7	-5.4	4.5	10.0
Imports	-4.1	-14.4	20.0	15.0
Inflation (yoy%)				
CPI (annual average)	10.4	6.3	8.6	5.2
CPI (end of period)	10.1	6.5	7.0	6.0
Fiscal Accounts (%GDP)				
Central Government Balance	-1.8	-5.5	-3.6	-2.7
Gross Public Debt	39.5	45.4	42.0	40.5
Primary Balance	3.5	0.1	0.8	1.5
Labor Statistics (%)				
Unemployment Rate (%of labor force)	13.6	14.0	11.9	11.0
External Accounts				
Current Account (% GDP)	-5.7	-2.3	-6.4	-7.0
Net FDI (USD)	17.0	6.9	7.1	7.0
FDI / Current Account	40.4	49.0	14.7	12.0
FX Reserves (USDbn)	71.0	69.0	79.0	90.0
Domestic Credit	**2009**	**Q1 10**	**Q2 10**	**Q3 10**
Total Credit (%GDP)	34.8	31.6	35.4	37.5
Credit Private Sector (%GDP)	32.9	29.9	33.6	35.6
FX Credit/Total Credit (%)	14.9	16.9	18.7	18.8
Private Sector Credit (%yoy)	11.3	22.8	34.0	36.7
Loans to Deposits	78.7	79.9	82.1	84.3
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	6.25	6.25	6.50	7.50
USD/TRY (where applicable)	1.60	1.60	1.50	1.45

Source: National Sources, Eurostat, IMF, Eurobank Research & Forecasting

Rising oil prices represent a significant risk for the Turkish economy

Heightened political tensions in North Africa and the Middle East have increased international worries over the social, economic and geopolitical stability in the broader region. Regarding the current crisis in Libya, a number of recent reports attempted to shed some light on the potential implications for the Turkish economy, especially in view of the country's geographic proximity to the region. Based on the most recent data (2010), contagion from the trade channel appears to be relatively limited. Turkey's exports to Libya accounted for just 1.7% of total exports, totaling $1.9bn and corresponding to 0.3% of Turkish GDP. Meanwhile, imports from Libya amounted to $0.4bn, or 0.2% of total imports suggesting little dependence on Libya's energy products. That said, Turkish construction companies have a high exposure in the country, with projects there estimated to be worth some $15.3bn. Even so, construction accounted for just ca 2% of Turkish GDP in the first nine months last year. The recent spike in oil prices against a background of political unrest in the Middle East is, in our view, the primary source of concern as it bears potential of exerting widening pressures on the current account deficit and posing supply-side risks to inflation. It is worth noting that CBT Governor, Durmus Yilmaz, said recent that the pass-through to annual inflation for every 10 USD increase in oil prices is estimated to be as significant as 40bps.

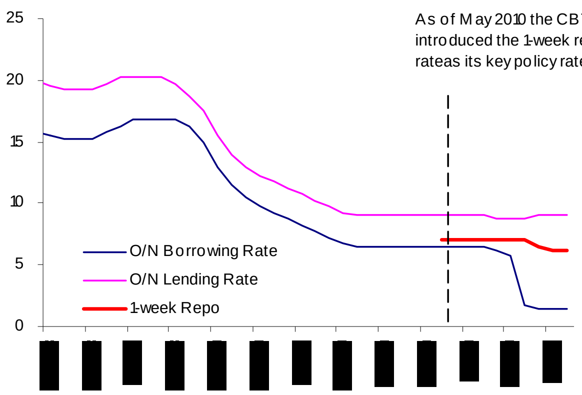
Turkish CPI hits new four-decade low in February

Headline CPI rose by 0.73%mom in February, coming in above the market's median forecast for a 0.64% increase. The breakdown of the report revealed that food prices rose for the second month running, advancing by 2.54%mom. The latter probably suggests that the correction in food prices witnessed late last year (+7% yoy in December vs. double-digit gains in August-November) came to a halt in January. The breakdown of the report showed that three of the twelve CPI sub-indices declined on a monthly basis; namely "recreation & culture", "housing" and "clothing & footwear". The majority of the rest recorded modest increases. On an annual basis, headline CPI eased to a new four-decade low of 4.16% in February, from 4.90%yoy in the prior month. This compares with the Central Bank's 5.9% yoy year-end projection and the 5.5% yoy official target. Underlying inflation pressures remain relatively subdued, with five of the nine core inflation indices easing on an annual basis. However, the CBT's favorite measures "H" (CPI excluding unprocessed food products, energy, alcoholic beverages, tobacco products and gold) and "I" (excluding energy, food, beverages, tobacco products and gold), extended their recent uptrend in February, albeit standing ca 120bps higher each from respective historic lows of 3.02% and 2.50% touched in October 2010. Meanwhile, February's PPI also exceeded expectations of 1.30%mom rising by 1.72%mom, pointing to increased cost-push pressures. On an annual basis, PPI rose by 10.87%, a tad above January's 10.80% increase. We expect domestic inflation pressures to become more evident after April as the effect of favorable base effects gradually wanes and the output gap narrows further. Higher oil prices, domestic food inflation and FX fluctuations remain key upside risks to our forecasts.

CBT leaves policy unchanged in February

Turkey's Central Bank kept its key policy rate, the 1-week repo rate, unchanged at a record low level of 6.25% at its MPC meeting in February. The overnight borrowing and lending rates were also held stable at 1.5% and 9.0%, respectively. The move was broadly in line with the market expectations and comes as the Central Bank purportedly awaits to assess the full impact of a rather unconventional mix of measures implemented since last December (*i.e.,* a 75bps cut in the key policy rate, a wider corridor for the o/n bid-offer rates and higher reserve requirements on short-term TRY deposits). Looking ahead, we believe that the CBT may abstain from delivering any further rate cuts in the months ahead as inflation is likely to pick up pace from Q2 onwards. Note here that the lira depreciated 6% against the USD since December, when the current policy mix was introduced. Moreover, according to government estimates the Central Bank's policy measures have already prompted around $10bn of short-term capital outflows. The latter is in line with the CBT's plans to curb hot money inflows and safeguard domestic financial stability. Capital inflows to Turkey rose sharply in 2010, driven by high interest rate differentials, sound domestic macro fundamentals, strengthening political stability and increased prospects for sovereign credit rating upgrades. Given that the latest CPI reading touched a four-decade low we anticipate that the CBT will not be in a hurry to hike its key policy rate in the imminent future. Notwithstanding the aforementioned, further hikes in the reserve requirement ratios are likely in the coming months. Furthermore, we expect around 150bps of cumulative hikes in the 1-week repo rate in H2:2011 as inflation pressures become more pronounced.

Figure 1: CBT holds fire in February



Source: CBT, National Statistics

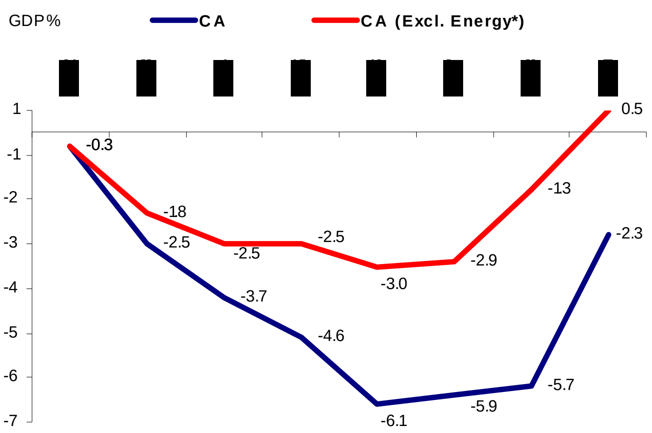
Fiscal position improves further in early 2011

After outperforming last year's deficit target of 4.0%-of-GDP (final deficit outcome was 3.6% of GDP), the consolidated central government budget position improved further earlier this year. In January 2011, the budget swung into a surplus of TRY 1.01bn from a TRY 3.12bn deficit in the same month a year earlier. The improvement was primarily driven by a 14.2%yoy rise in tax receipts, thanks to favorable cyclical factors, adding to the view that December's sharp deficit deterioration (i.e., 175%yoy increase in the shortfall) is unlikely to prove sustainable. Total revenues jumped 20%yoy in January, while expenditure fell by 0.7%yoy. Moreover, the primary surplus, which excludes interest payments on government debt, jumped 62%yoy to TRY 4.8bn. With general elections looming in July, the government has repeatedly pledged commitment to fiscal prudence. In view of the strong support the ruling AKP party is currently enjoying and its recent commitment to fiscal consolidation, we see little risk of significant slippages in the run-up to the polls. As such, we continue to anticipate that the government's deficit target of 2.8%-of-GDP this year will be met. Taking into account growing risks on the current account deficit and inflation, especially in view of ongoing tensions in the Middle East, fiscal prudence is key in order to maintain stability and investor confidence towards the country.

Trade deficit widened further in January on strong imports growth

Turkey's current account deficit soared by 132%yoy to a record high of $7.5bn in December, exceeding the market's median forecast for a shortfall of $7.0bn. For the whole of 2010, the current account deficit widened 247%yoy to a lifetime high of $48.56bn, which according to our calculations corresponds to ca 6.4%-of-GDP. This marks a significant deterioration from a 2.3%-of-GDP shortfall in 2009, rendering the current account deficit a serious macro vulnerabilities at the present trajectory. Meanwhile, although net FDI inflows rose by 4%yoy to $7.1bn in 2010, they covered no more than 15% of the external shortfall. The latter deems the financing of the current account gap highly susceptible to sudden shifts in foreign investor sentiment. Last year's current account widening was primarily driven by a higher trade shortfall against a background of growing divergence between domestic and external demand dynamics and rapid credit expansion. In view of the aforementioned, the CBT adopted in December a rather unconventional monetary policy mix, aiming to contain domestic credit creation and import growth. Even so, a convincing impact on the external imbalance has yet to be witnessed. Although the CBT estimates that around $10bn of "hot money" has left Turkey as a result of the measures, January's trade deficit soared by 89.4%yoy to $7.31bn, coming in well above the market's median deficit forecast of $4.35bn, as imports growth sharply outpaced the growth of exports (44.3%yoy vs. 22.1%yoy). Nevertheless, CBT Governor Durmus Yilmaz has already warned that the current account deficit is likely to widen further in Q1 on base effects, before the impact of the measures becomes more pronounced thereafter. Notwithstanding the aforementioned, we continue to expect the current account deficit to deteriorate further this year, reaching around 7.0%-of-GDP on the back of ongoing domestic demand pressures, relatively subdued exports and higher commodity prices. It is worth noting that Turkey is a major energy importer, with ca 95% of crude used being imported. The government estimates that the current account excluding the energy price impact was in a surplus of 0.5%-of-GDP in 2009 vs. a 2.3%-of-GDP deficit accounting also for energy prices.

Figure 2: Energy imports weigh on the current account deficit



Source: CBT, National Statistics

Written by

Galatia Phoka
Emerging Markets Analyst
gphoka@eurobank.gr

II. New Europe – Country Analysis: **Ukraine**

2011 outlook looks encouraging

- Real GDP growth slowed to 3.0% yoy in Q4-2010, from 3.4% yoy in the prior quarter, mainly due to base effects. Consumer spending revival and higher investment ahead of the Euro 2012 football championships to provide further support to economic activity in the period ahead
- Ukrainian authorities agreed with the IMF to continue fiscal consolidation in 2011. The programme aims to reduce the combined general government and Naftogaz deficit ceiling to 3.5% of GDP in 2011 and to 2.5% of GDP in 2012, from 8.9% of GDP last year
- Headline inflation resumes downward trend
- High NPLs act as a drag on domestic bank lending, while deposits have reached pre-crisis levels

Consumer spending revival and higher investments ahead of Euro 2012 football championship to continue supporting domestic economy

According to preliminary estimates of the State Statistics Committee, the Ukrainian economy expanded by 4.2% yoy in 2010 recovering from a contraction of 15.1% yoy in 2009. Ukrainian GDP grew by 3.0% yoy in Q4-2010, slowing from 3.4% yoy in Q3-10. The slowdown was largely due to the low comparison base effect of 2009 (Table 1).

Table 1: Ukrainian GDP growth dynamics in annual basis

Q1-09	Q2-09	Q3-09	Q4-09	Q1-10	Q2-10	Q3-10	Q4-10
-20.2	-17.8	-16	-6.8	4.9	5.9	3.4	3.0

Source: National authorities

While the recovery in the first semester of 2010 was driven by net exports due to the rebound in commodity prices (in particular, steel prices), in the second half of the year this source of support faded as imports rebounded and steel prices softened. In turn, private consumption has shown signs of revival, supported by faster wage growth. Real wage growth stood at 8.7% yoy in January 2011 from 6.4% yoy in September 2010 (average nominal private sector wages were up by 16.1% yoy in 2010). Reflecting the revival of consumer spending, retail sales has recorded strong gains in recent months, reaching double-digit growth in January 2011 (+11.1% yoy), up from 7.8% yoy in December. On the other hand, industrial production grew by 9.7% yoy in January decelerating from 12.5% yoy in December.

Ukraine: Eurobank EFG Forecasts

	2008	2009	2010f	2011f
Real GDP (% yoy)	2.3	-15.1	4.2	4.5
Private Consumption	9.9	-12.1	4.7	5.0
Government Consumption	0.4	1.8	1.5	1.0
Gross Capital Formation	32.6	-48.4	8.0	15.0
Exports	5.1	-23.6	9.0	9.0
Imports	18.4	-36.8	10.0	11.0
Inflation (% yoy)				
CPI (annual average)	25.2	15.9	9.4	10.6
CPI (end of period)	22.3	12.3	9.1	10.3
Fiscal Accounts (% GDP)				
General Government Balance	-3.2	-8.7	-6.5	-3.5
Gross Public Debt	20.5	35.3	41.7	42.4
Labor Statistics (%)				
Unemployment Rate (% of labor force)	6.9	9.4	8.5	8.0
Wage Growth *(real - private sector)*	6.3	-10.3	6.7	7.0
External Accounts				
Current Account (% GDP)	-7.0	-1.5	-1.9	-2.5
Net FDI (bn USD)	9.9	4.7	5.7	7.0
FDI / Current Account	77.6	268.0	222.0	100.0
FX Reserves (bn USD)	31.5	26.5	34.6	37.0
Domestic Credit	**2008**	**2009**	**Q2 10**	**Q3 10**
Total Credit (% GDP)	77.3	79.1	70.8	69.7
Credit to Enterprises (% GDP)	46.7	50.5	46.6	46.7
Credit to Households (% GDP)	29.5	26.4	22.3	20.9
FX Credit/Total Credit (%)	59.0	50.8	48.4	47.4
Private Sector Credit (% yoy)	68.5	-3.1	1.4	2.6
Loans to Deposits	204.0	215.9	192.2	183.3
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	7.75	7.75	7.75	7.75
USD/UAH	7.93	7.90	7.90	7.90

Source: NBU, IMF, Bloomberg, Eurobank Research

We anticipate GDP growth to accelerate to 4.5% in 2011 on the back of higher fixed investment ahead of Euro 2012 football championships, coupled and strengthening consumer spending dynamics.

Fiscal consolidation to continue in 2011

According to the IMF's First Review under the Stand-By-Arrangement, the country's fiscal performance has been broadly in line with the Programme's targets. General government revenue increased at a slower pace than envisaged year-to-September 2010, but tight expenditure control kept the 2010 deficit under the programme ceiling of 6.5% of GDP. The Ukrainian authorities agreed to insist in their fiscal consolidation effort in 2011. The programme aims to reduce the combined general government and Naftogaz deficit ceiling to 3.5% of GDP in 2011 and 2.5% of GDP in 2012 from what realised levels in 2010. Regarding the energy sector, Naftogaz deficit is expected to drop to 0.4% of GDP in 2011; Naftogaz's financial position is projected to balance by 2012. A further 50% gas price hike, effective by April 15, has to be approved by the Ukrainian parliament by March 31, 2011. As far as structural reforms are concerned, the authorities agreed to reduce the corporate profit tax rate by 2% per year through 2013. Yet, the new tax code, if successfully implemented, would have a broadly neutral revenue impact in 2011, as there counterbalancing changes. Moreover, the authorities have to submit to parliament legislation on pension reforms, which are estimated to bring immediate savings of about 0.4% of GDP in 2011, gradually rising to about 2.5% of GDP per annum over the long term. Regarding the 2011 budget, there is a projected an increase of capital spending by 3% of GDP so as to meet project commitments for the Euro 2012 football championships (31.1bn hryvnias - ca 2.8% of 2010 GDP - is estimated to be spent on public projects related to Euro 2012 preparations in 2011) and for basic infrastructure upgrades which were compressed in recent years.

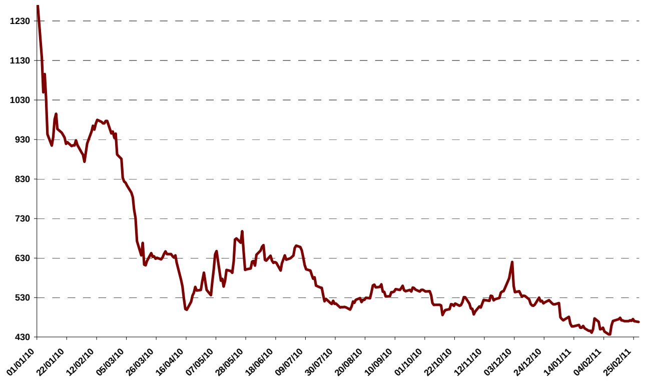
Ukraine regains access to international capital markets

Following the successful issuance of $2bn Eurobonds with 10 year maturity in September (at a 7.5% yield) the government placed in mid-February a $1.5bn Eurobond issue that will mature in 10 years with a yield of 7.95% per annum. CDS spread on sovereign 5-year debt fluctuated around 470-480bps, in mid- February 2011 compared to 970-980bps in mid-February 2010, when incumbent Ukrainian President Viktor Yanukovych won the country's presidential elections (Figure 1). These positive developments facilitated a built up in gross international reserves to $34.6bn as of end-December 2010.

Domestic inflation resumes downward trend

Inflation has followed a downward path since the third quarter of 2010, easing for a fourth consecutive month in January 2011 (8.2% yoy vs. 9.1% yoy in December 2010). The drop was mainly driven by a rapid decline in food price inflation (8.6% yoy in January 2011 vs. 10.6% yoy print in the prior month). Moreover,

Figure 1: CDS spread on sovereign 5-year debt indicate perceived sovereign risk is abating



Source: Bloomberg

fuel and household energy prices continued to be the main source of inflation pressures. Given that authorities agreed with the IMF on a further 50% hike in gas tariffs, effective by April 15, and the surge in global oil prices, headline inflation will remain elevated over 2011; we expect an average 10.6% yoy inflation rate this year.

High level of NPLs acts as a drag on domestic bank lending deposits have reached pre-crisis levels

Total credit growth returned to positive territory in recent months, reaching 3.1% yoy in January 2011. However, credit to households remained stalled on the back of fears of high credit risk in the sector (-11.7% yoy in January 2011). On the other hand, credit to enterprises has shown some signs of revival lately, reaching 10.3% yoy growth in January 2011 following its 2010 upward trend. What's more, deposits have reached pre-crisis levels; they grew by 30.0% yoy in January 2011. Nevertheless, the banking sector remains unprofitable with a return on assets of around -2% in 2010.

NPLs have risen to high levels and represent a major challenge to bank balance sheets and the resumption of lending. According to IMF's broad[1] definition, NPLs to total loans ratio stood at 41.2% in September 2010 from 40.3% recorded in March 2010 and 37.9% in 2009. Even with the narrow[2] IMF definition, NPLs to total loans

1 Includes NPLs that are classified as substandard, doubtful and loss. Yet, in addition to servicing status, loan classification also depends on borrower's financial conditions and collateralization level.
2 Excludes substandard loans in a timely manner.

ratio stands at high levels and keep rising; it reached 17.0% in September 2010 from 15.2% in 2009.

Written by

Dr Stella Kanellopoulou
Research Economist
Skanellopoulou@eurobank.gr

A few words about Eurobank EFG Group

A European banking group that actively supports the economy.

Eurobank EFG group is a European banking organization with total assets of €86.5 bn, employing over 22,500 people and offering products and services through a network of more than 1,600 branches, business centres and points of sale, as well as through alternative distribution channels.

Eurobank EFG group has a systemic presence in 10 countries: Greece, Bulgaria, Serbia, Romania, Turkey, Poland, Ukraine, the UK, Luxembourg and Cyprus. It is a member of the EFG Group, an international banking group present in 40 countries.

Our strategy as a European banking group is mirrored in our history, our financial strength and our steady business expansion in the wider region of Central and South – eastern Europe, where we offer responsible banking based on innovative products and quality service. The performance of the Eurobank EFG people is recognized through numerous awards and distinctions that the Group receives at a local and international level.

Strong capital position and liquidity, vigilant risk management, a successful track record of steady growth, efficiency and solid profitability, as well as top quality personnel ensure the creation of value to the benefit of our clients and shareholders.

More information about Eurobank EFG Group can be found at http://www.eurobank.gr

Research Team

Editor, Professor **Gikas Hardouvelis**
Chief Economist & Director of Research Eurobank EFG Group

Financial Markets Research Division
Platon Monokroussos, *Head of Financial Markets Research Division*
Paraskevi Petropoulou, *G10 Markets Analyst*
Galatia Phoka, *Emerging Markets Analyst*

Sales Team
Nikos Laios, *Head of Sales*
Vassilis Gioulbaxiotis, *Head of International Sales*
Yiannis Seimenis, Ioannis Maggel, *Corporate Sales*
Stogioglou Achilleas, *Private Banking Sales*
Alexandra Papathanasiou, *Institutional Sales*

Economic Research & Forecasting Division
Dimitris Malliaropulos, *Economic Research Advisor*
Tasos Anastasatos, *Senior Economist*
Ioannis Gkionis, *Research Economist*
Stella Kanellopoulou, *Research Economist*
Olga Kosma, *Economic Analyst*
Maria Prandeka, *Economic Analyst*
Theodosios Sampaniotis, *Senior Economic Analyst*
Theodoros Stamatiou, *Research Economist*

Eurobank EFG, 20 Amalias Av & 5 Souri Str, 10557 Athens, tel: +30.210.333 .7365, fax: +30.210.333.7687, contact email: Research@eurobank.gr

Eurobank EFG Economic Research

More research editions available at http://www.eurobank.gr/research

- **New Europe**: Economics & Strategy Monthly edition on the economies and the markets of New Europe
- **Economy & Markets**: Monthly economic research edition
- **Global Economic & Market Outlook**: Quarterly review of the international economy and financial markets

Subscribe electronically at http://www.eurobank.gr/research